

**Malta: Financial System Stability Assessment,
including Reports on the Observance of Standards and Codes on
the following topics: Monetary and Financial Policy Transparency,
Banking Supervision, Securities Regulation, Insurance Regulation,
Corporate Governance, and Payment Systems**

This Financial System Stability Assessment on **Malta** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **July 21, 2003**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **Malta** or the Executive Board of the IMF.

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MALTA

Financial System Stability Assessment

Prepared by Monetary and Financial Systems Department

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July 21, 2003

This Financial System Stability Assessment (FSSA) is based on two joint IMF/World Bank Financial Sector Assessment Program (FSAP) missions that visited Malta from October 15 to 25, 2002 and January 27 to 31, 2003. An update was made on the occasion of the Article IV consultation mission May 14–16.

The mission received full cooperation from the authorities and held discussions with the Minister of Finance, the Governor of the Central Bank of Malta, the Chairman/President of the Malta Financial Services Authority, and other government officials. The mission also met with representatives of banks, insurance companies, investment funds, stockbrokers, audit firms, professional association for the financial sector, and other market participants. The mission comprised Piero Ugolini (IMF/MFD, mission chief), Paula Perttunen (World Bank, deputy mission chief), Margarita Aguilar (administrative assistant), Terry Donovan, Sandra Marcelino, Andrea Schaechter, and Mark Zelmer (all IMF/MFD); Laura Ard, Luc Cardinal, Peter Kyle, and Elisabeth Sherwood (all World Bank), Karsten Biloft (Danmarks Nationalbank), and Paolo Corradino (Banca d'Italia). The AML/CFT assessment benefited from the participation of Giulio Sanarighi (Maggiore of the Italian Guardia di Finanza).

Malta's financial system appears to be healthy and well supervised, but very concentrated and exposed to the country's narrow economic base. Financial soundness indicators and stress tests show that the domestic banks are profitable, liquid, and well capitalized. Two domestic banks account for about 90 percent of total assets and if either were to fail, it could trigger a systemic crisis.

Malta has a comprehensive legal framework and strongly adheres to most of the international standards and codes. A new central bank law providing more autonomy to the central bank and officially establishing price stability as the main objective was introduced in October 2002. Malta's legal framework comprises essential elements for AML and CFT.

Notwithstanding, the healthy status of the financial sector, the mission made several recommendations to further strengthen the resiliency of the system, in particular, (a) an effective cooperation between the single regulator for the financial sector and the monetary authority to ensure the financial stability and the soundness of the financial sector; (b) a close monitoring of the quality of the banks' assets and a reduction in the level of NPLs; and (c) a need to specifically criminalize financing of terrorism and provide additional resources and expertise in the AML/CFT area.

The main authors of the report were Piero Ugolini, Mark Zelmer, and Andrea Schaechter.

FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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List of Acronyms

AML	Anti-money laundering
CBM	Central Bank of Malta
CFT	Combating the financing of terrorism
CIS	Collective Investment Schemes
CP	Core Principle
CPSIPS	Core Principles for Systemically Important Payment Systems
CPSS	Committee on Payment and Settlement Systems
CSD	Central Securities Depository
CSS	Central Systems of Securities Settlement
DVP	Delivery versus payment
EU	European Union
FATF	Financial Action Task Force
FIAU	Financial Intelligence Analysis Unit
FT	Financing of terrorism
IAE	Independent AML/CFT Expert
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IOSCO	International Organization of Securities Commissions
KYC	Know your customer
LOLR	Lender of last resort
MaRIS	Malta Real-Time Interbank Settlement System
MFP Code	Code of Good Practices on Transparency in Monetary and Financial Policies
MFSA	Malta Financial Services Authority
ML	Money laundering
MSE	Malta Stock Exchange
NPL	Nonperforming loans
PDAC	Public Debt Advisory Committee
PMLA	Prevention of Money Laundering Act, 1994 (as amended)
PMLR	Prevention of Money Laundering Regulations, 1994
RIE	Recognized Investment Exchange
RTGS	Real Time Gross Settlement System
STR	Suspicious Transaction Report
SWIFT	Society of Worldwide Interbank Financial Telecommunications
UN	United Nations

I. OVERALL STABILITY ASSESSMENT

1. **Malta's financial system is sound and well supervised, but very concentrated and exposed to the country's narrow economic base.** Domestic banks dominate the financial sector. They account for 90 percent of total financial sector assets and have affiliates and subsidiaries in the insurance and securities sectors. Their activities are largely funded by domestic currency deposits from residents.¹ There is also a separate international component of the banking system but it does not appear to be a source of systemic vulnerability. Financial soundness indicators and stress tests suggest that the domestic banks are healthy. The financial system has never experienced a system crisis. However, the limited diversification of banks' loan portfolios, the strong reliance on real estate properties as collateral, some inefficiencies in the judicial system hindering rapid collateral liquidation, and the high concentration of domestic banking activities in two banks weaken the resiliency of the banking system to large economic shocks. The insurance and securities segments are small and not systemically important.

2. **The Maltese authorities have a comprehensive legal framework and strongly adhere to most international standards and codes.** A new central bank law providing more autonomy to the central bank and officially establishing price stability as the main objective was introduced in October 2002. In addition, the supervisory framework has been further strengthened over the past several years to bring it in line with EU standards, and the authorities' capacity to manage the vulnerabilities in the financial system is improving rapidly. A contingency plan designed to help coordinate authorities' action in the event of a crisis in place and a regulation approving the creation of a Deposit Guarantee Scheme and the Investor Compensation Scheme entered into force on January 3, 2003. The level of transparency in monetary and financial policies is generally high, and all institutional elements of an Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) regime are now in place.

3. **Notwithstanding the healthy state of the financial sector and its modern supervisory and regulatory framework, several recommendations were made (Box 1) to further strengthen the financial sector and increase its resiliency to economic shocks.** In the banking supervision area, two of the main recommendations were to encourage the close cooperation and exchange of information between the central bank and the supervisory authority (MFSA) in order to fulfill their statutory responsibilities, and a reduction of the nonperforming loans (NPLs), which are higher than normal EU average. In the latter case, a

¹ The other banks licensed in Malta are classified by the authorities as "international banks". For the most part, they comprise Austrian and Turkish banks that deal mainly with nonresidents and that were established in Malta for tax purposes. They do not appear to be a source of systemic vulnerability. Malta also operated a specific offshore regime, with lighter regulatory standards, which is being wound down, with the sole remaining bank planning to convert to an "international" licensed bank during 2003.

close monitoring of the asset quality of the banks will be essential. In the area of financial markets, the key issue is to introduce a proper legal and regulatory foundation for the securities settlement system. With regard to AML/CFT, while progress in phasing out the offshore sector is at an advanced stage, recommendations were made to address reputational risk issues, including those related to nominee companies, and Malta's plans for new trust legislation. Additional technical recommendations were made in other areas.

Box 1. Summary of Mission Recommendations

The mission identified some areas where authorities' actions would be required to improve the overall supervisory framework and the resiliency of the financial sector. In particular, the mission emphasized the paramount importance of **maintaining the health and viability of the two largest banks.** In view of the crucial role played by these two banks, it is essential that they be closely supervised and that any required intervention be prompt, in order to avoid systemic crisis. Other recommendations are listed below by sector.

Banking sector: Given the high concentration of bank loan portfolios and strong reliance on collateral, banks need to continue holding more capital and provisions than is currently required by the prudential norms so they can, if necessary, absorb shocks that are more sectoral in nature. They also need to continue improving their credit risk management system so that they can monitor exposures and set provisions in a more proactive fashion. A reduction of the NPLs level and a close monitoring of the banks' asset quality will be essential to ensure the soundness of the banking sector.

Banking supervision: At the institutional level, the recent establishment of a single regulator for the financial sector has created a new situation in which effective cooperation between the CBM and the MFSA is important to ensure financial stability and soundness of the financial sector. Therefore, it is essential that the two institutions develop a close working relationship to ensure that each institution has access to all the relevant information required to fulfill its statutory responsibilities. To this end, the signing of a formal Memorandum of Understanding (MoU) in February 2003 providing for the creation of appropriate consultative mechanisms is a very important first step. This should go hand in hand with strong cooperation among the officials of the two institutions. On the operational side, a set of recommendations are listed in Section IV.G.

Payment system: The recovery time in case of a breakdown should be reduced to less than four hours, the draft contingency plan should be completed and tested, and consideration given to setting up a remote back-up site. The CBM was also encouraged to complete the process of establishing an effective oversight function.

Securities settlement systems: The legal framework governing the central securities depository should be improved as its legal status changed in October 2002, when the MSE officially became a recognized investment exchange (RIE). The authorities were encouraged to take steps to address the need for a separate legal and supervisory framework to govern the depository's activities. Such actions should be taken so that Malta's securities settlement system can eventually be integrated with other European systems, and Maltese government securities accepted as collateral in the European System of Central Bank's monetary operations (should Malta eventually join the European Monetary Union). As an immediate priority, the Maltese authorities should make sure that the introduction of delivery versus payment in the securities settlement system moves forward as planned. With regard to the supervision and regulation of the securities depository and settlement system, the MFSA and CBM should cooperate closely and establish their respective roles in an MoU.

Capital markets supervision: The MFSA and the MSE need to clearly delineate their respective roles and responsibilities with the aim of optimizing the use of scarce resources and avoiding supervisory, surveillance, and enforcement gaps.

Box 1. Summary of Mission Recommendations (Continued)

Insurance supervision: Work is also needed to improve the supervision of insurance company internal controls and investment policies. In addition, the MFSA's supervision of insurance company corporate governance procedures should be formalized, and it should move to a more formal risk-based approach to supervision.

Public debt management: The CBM's role in the government securities market should be reviewed once the planned primary dealer system is implemented. More generally, the government should continue using its public debt management activities as an instrument to foster a deeper and more liquid secondary market for government securities, and it would be prudent for the government sinking funds to reduce their risk exposure.

AML/CFT: The authorities should ensure that the financing of terrorism is fully and specifically criminalized. Moreover, the newly introduced elements of the comprehensive methodology should be swiftly implemented, particularly those relating to the Basel Committee's Customer Due Diligence paper. In relation to nominees (and trustees under the proposed new legislation), financial institutions should be required to verify the due diligence carried out by nominees/trustees, to help to minimize the reputational risk to Malta from the continuation of this category of business. With regard to dealings by financial institutions with other professional intermediaries acting on behalf of clients, information on the identity of the beneficial owner/client should be made available to the financial institution. There is also a need to provide some additional resources and expertise in AML/CFT in the MFSA, increase the frequency of on-site inspections, and extend the coverage to include a sample of domestic branches. As the FIAU develops and becomes more adequately resourced to assist in raising further the level of awareness in the industry, it is expected that some increase in the level of suspicious transaction reports will follow.

Transparency: To further increase transparency in monetary policy, the CBM should clarify the objectives and procedures of its operations in the government securities market. Moreover, the CBM should frequently disclose its off-balance-sheet commitments, and issue an annual income statement. Once the payment systems oversight function is established, the CBM should publicly disclose the related policies, objectives, and procedures, and there is a need to disclose the arrangements for information exchange between supervisory and regulatory authorities on the domestic as well as international level.

A. Financial System Soundness

4. **The domestic banking sector, which comprises four banks, is dominated by two banks that account for 90 percent of the sector's assets.** The government has a 25 percent stake in one of them, Bank of Valletta. There are no significant links between the domestic and international segments of the banking system described in footnote 1. The Central Bank of Malta's (CBM) financial stability office monitors the financial situation of local large borrowers as part of the Early Warning System.

5. **The Maltese banking system is healthy but exposed to the country's narrow economic base.** Financial soundness indicators indicate that the domestic banks are profitable, liquid, and well capitalized. However, the soundness of the banking system is highly dependent on the financial condition of the two largest institutions and could be undermined in the event of a major economic shock of a systemic nature given the high concentration of banks' loan portfolios and the banks' strong reliance on domestic real estate properties as security in their lending operations. Looking forward, Malta is well placed to benefit from EU accession, albeit banks may face some relevant challenges from increased

competition. This is particularly relevant for one of the domestic banks in which the government is seeking buyers for its 25 percent stake as part of its privatization program.

6. **The insurance and capital market sectors are small and at an early stage of development.** The largest institutions in both markets are affiliated with the two large domestic banks. Although these sectors are fairly small, it is important to emphasize that Maltese residents have significant investments offshore, and a long history of accessing foreign financial institutions to manage their savings.

7. **All remaining business (bank and nonbank) operated under the specific offshore legislation will be phased out by September 2004.** Going forward, all business with non-residents will be regulated on the same basis as for domestic banks and nonbanks. In addition, the complete elimination of regulated nominee company structures is being considered by the authorities under draft legislative proposals, which would also update trust law and provide for regulated trustees, in part with a view to attracting “regulated” international business. While involvement in offshore activities (particularly if widely defined to include all dedicated international financial services businesses) carries with it a reputational risk for Malta, the mission did not observe any additional factors giving rise to particular negative implications for the stability of the Maltese financial system.

8. **The liquidity management framework and the payment systems are sound and not vulnerable to systemic risks.** The CBM manages liquidity by using indirect instruments and has the explicit mandate to provide collateralized liquidity as a lender of last resort (LOLR). The Real-Time Gross Settlement System (RTGS) payment system, which became operational in October 2002, is cost-effective and functions well. The retail payments infrastructure, on the other hand, remains relatively fragmented. However, the authorities and the banks are working on a project to integrate the various systems.

9. **Some relevant vulnerabilities exist in the securities settlement system.** At present, there is no delivery-versus-payment (DVP) for securities transactions. However, significant steps have already been taken to ensure the necessary legal and technical foundation for the introduction of DVP. There is no formal supervision over the central securities depository that is part of the Malta Stock Exchange (MSE). Moreover, since the depository’s legal framework is embedded in the by-laws of the MSE, this could create serious uncertainty in the (unlikely) event that the exchange was to lose its license. The authorities are taking steps to address the need for a separate legal and supervisory framework to govern the depository’s activities.

B. Supervision and Regulation

10. **The authorities have made major efforts in strengthening the supervisory framework in line with international standards and codes.** The Malta Financial Services Authority (MFSA), which supervises the insurance and securities sectors, also assumed from the CBM the responsibility for supervising banks in January 2002. The CBM retains responsibility for supervising the payments system and for monitoring the financial system’s

overall stability through its analysis of financial soundness indicators and the results of its quarterly stress test exercise. Accounting and audit standards are high.

11. **The MFSA's supervision of banks is good.** Over the years, the authorities have made significant progress in creating a supervisory framework that is independent and effective. The most recent and notable steps taken in this regard have been the creation of an independent supervisory agency, and the continued revision of laws and directives to further incorporate EU requirements and overall international best practices. The supervisory effort of the authorities is well supported by qualified and experienced staff who oversee the banking sector through on- and off-site processes.

12. **The MFSA has made considerable progress since 1994 in creating and building an insurance supervision function.** All insurance companies and intermediaries have been inspected at least once since then, and the authorities are currently revising the business forms aimed at enhancing the offsite supervisory framework.

13. **The regulation of the Maltese securities market is presently undergoing a significant transition,** which is expected to be completed in 2003. Recent legislative amendments aim to create a single regulatory authority for the capital market in the MFSA, with the MSE retaining a status of Recognized Investment Exchange (RIE). All regulatory powers have accordingly been placed in the MFSA, and, with the exception of listing requirements, appropriate legislation has been issued. More detailed directives to RIEs were issued in April 2003. An enforcement track record under the new regime still needs to be established.

14. **The authorities' operation of the payments system is good, while further work is needed to improve the securities settlement system.** The CBM operates the RTGS payment system and is working to improve the oversight of the system. Being an integral part of the MSE, it is difficult to separate the function of the Central Securities Depository (CSD) from those of the MSE. As a consequence, there is no direct supervision of the CSD. There are no laws in Malta that address the issues related to the securities settlement process in general and the function of a CSD in particular.

15. **All of the institutional elements of an anti-money laundering regime are now in place in Malta following the recent establishment of the Financial Intelligence Analysis Unit (FIAU).** Malta's legal framework includes the essential components for AML and CFT. However, some points are not covered explicitly in legislation, with reliance placed on interpretations of common law. Financing of terrorism is not yet fully criminalized. AML/CFT implementation measures for all financial institutions regulated by the MFSA are well developed and were observed in practice in banks, securities firms, and insurance entities. For the most part, however, the newly introduced elements of the comprehensive methodology have yet to be implemented.

16. **Monetary and financial policies are conducted in a transparent manner.** The authorities have undertaken considerable efforts to increase transparency and use a variety of

channels for public disclosure, including annual and more frequent reports, press releases, brochures, and speeches by officials.

II. MACROECONOMIC ENVIRONMENT AND RISKS

17. **Malta's economy is highly dependent on a few sectors, such as tourism and manufacturing, and is, thus, heavily influenced by external developments.** Malta is a small island economy with a population of about 394,000 and a GDP per capita of about US\$9,200 (one of the highest among the EU accession countries). Tourism and manufacturing are the dominant sectors accounting for more than 50 percent of GDP. Electronic products make up three-quarters of manufactured exports. The government's involvement in the economy remains high, notwithstanding the ongoing reform strategy of reducing the government's stake in enterprises. Public administration and state-owned enterprises account for about one-fourth of GDP and employ about one-third of Malta's labor force.

18. **The weak performance of Malta's economy in 2001 and 2002 has slowed credit growth.** The slowdown in the economy has also contributed to raising the levels of NPLs although it is difficult to quantify the exact impact since stricter credit risk management and reclassification of loans following on-site examinations occurred at the same time. Real GDP growth recovered somewhat to 1.0 percent in 2002 compared to a 1.2 percent drop of GDP in 2001, but lies considerably below the growth rates that Malta's economy experienced between 1997 and 2000, which exceeded 4 percent annually (Table 1). The recovery is mostly being driven by the public sector, while the performance of the manufacturing and tourism sectors remain weak.

19. **Strong growth in deposits combined with a slowdown in credit demand has led to a rapid buildup of liquidity in the banking system over the past two years.** Interest rates, which are now fully liberalized, have gradually fallen.

20. **Inflationary pressures from the buildup of liquidity have been modest.** Price developments are mostly determined externally due to Malta's exchange rate peg and the openness of its economy. Moreover, the level of economic activity is still below potential. However, housing prices are rising rapidly because of strong demand. At the same time, balance of payments surpluses have enabled the CBM to build up its level of reserves and strengthen its position to maintain the peg ahead of EU accession. The CBM's level of foreign reserves stood at about 50 percent of GDP or about nine months of imports of goods at end-2002.

21. **The private sector seems well placed to cope with the macroeconomic effects of joining the European Union.** A number of capital account restrictions have already been lifted or relaxed over the past five years. Remaining restrictions on short-term capital flows (in particular loans with a maturity of less than six months) are to be phased out before Malta

Table 1. Malta: Selected Macroeconomic Indicators, 1998–2003

Total population: 397,296 (December 2002)
GDP per capita: US\$9,740

	1998	1999	2000	2001	2002	May 2003	
<i>Real Sector (in percent)</i>							
Real GDP growth	3.4	4.1	6.4	-1.2	1.0	-1.9	7/
GDP (in millions of Liri)	1,362	1,456	1,562	1,634	1,675	...	
Inflation rate (2002=100) 1/	2.4	2.1	2.4	2.9	2.2	1.3	
Unemployment rate (end-of-period)	5.6	5.8	5.0	5.1	5.2	5.3	8/
<i>Monetary and credit data (end-of-period, percentage change)</i>							
Monetary base	4.3	7.3	3.9	0.6	8.0	8.4	
Money (M1)	9.1	11.0	2.3	6.9	7.0	9.7	
Broad money (M3)	8.6	9.9	4.0	8.4	10.4	6.9	
Domestic credit	10.4	9.6	9.7	6.6	3.3	2.9	
<i>Interest rates (end-of-period, in percent)</i>							
Yield on government bills 2/	5.5	5.0	4.9	4.5	3.7	3.5	
Yield on government bonds 3/	6.0	5.6	6.0	6.1	5.4	5.1	
Bank lending rate 4/	8.1	7.3	7.2	6.5	6.1	6.0	
Stock market index	1,211	3,278	3,376	2,200	1,871	1,922	
<i>Public finances (in percent of GDP)</i>							
Central government financial balance 5/	-10.2	-7.8	-5.5	-5.2	-5.9	-6.8	7/
Total outstanding public debt	56.0	57.6	59.2	61.9	64.3	67.8	7/
<i>Of which: domestic public debt</i>	52.6	54.6	56.7	59.5	61.6	65.1	7/
<i>Of which: external public debt</i>	3.4	3.0	2.5	2.4	2.7	2.6	7/
<i>External sector</i>							
Lira per US\$ (end-of-period)	0.38	0.40	0.44	0.45	0.40	0.37	
Trade balance (in percent of GDP)	-19.1	-18.2	-21.2	-15.6	-13.1	-15.9	7/
Current account (in percent of GDP)	-6.2	-3.4	-13.4	-4.5	-3.9	-11.2	7/
Overall balance of payments (in percent of GDP)	2.8	8.4	-8.5	2.9	3.8	-7.2	7/
Direct Investment, net (in percent of GDP)	7.2	21.3	16.7	7.1	-11.3	0.9	7/
Portfolio investment, net (in percent of GDP)	-2.4	-13.8	-22.0	-12.3	-10.4	-16.3	7/
Gross official reserves (millions of US\$)	1,696	1,794	1,471	1,682	2,209	2,541	
Reserve cover (months of imports) 6/	7.4	7.8	5.2	7.4	8.6	8.4	9/

Sources: Central Bank of Malta; National Statistics Office; and staff estimates.

1/ Twelve-month moving average. 2/ Three-month treasury bills. 3/ Ten-year government securities.
4/ Weighted average lending rate of deposit money banks. 5/ Figures for 2002 excludes Lm 11.3 million special dividend (0.7 percent of GDP) associated with the MIA privatization process. 6/ Imports of goods.
7/ Annualized data up to the first quarter 2003. 8/ February 2003. 9/ April 2003.

joins the EU. Levies and subsidies are also being lifted and there are expectations that Malta's economy will remain competitive.

III. SOUNDNESS AND VULNERABILITIES OF THE FINANCIAL SYSTEM

A. Banks

Domestic banks

Financial conditions

22. **The Maltese banking system is healthy but exposed to the country's narrow economic base** (Table 2). Bank profitability, as evidenced by return on assets, has been fairly stable in recent years at around 0.8 percent.² The growth of non-interest revenues and expenses has slightly lagged that of total assets. Bank loan portfolios are highly concentrated, notably in loans to the tourism, retail trade, manufacturing, ship repair/shipbuilding, and construction sectors. Although the concentration ratios are not high, in a small economy like Malta, the sectors tend to be more linked and correlated. Banks reported that domestic real estate properties represent almost three fourth of the collateral used as security in lending operations. Lending to nonresidents is insignificant, and more than 95 percent of lending to residents is denominated in Maltese liri.

23. **Domestic banks are currently very liquid.** All four banks' holdings of liquid assets as a share of short-term liabilities comfortably exceed the 30 percent prudential requirement. In light of the significant structural excess liquidity in the banking system, banks do not have a strong need for wholesale money market funding. For funding, domestic banks rely heavily on Maltese liri deposits from residents. Resident foreign currency deposits are not significant.

24. **Maltese banks also show strong capital levels that are well in excess of capital adequacy requirements.** Banks are allowed to take collateral values into account when setting provision requirements. While the banks' discounts on the value of collateral are considered prudent (30 percent discount from appraised value for real estate collateral) from the standpoint of dealing with individual problem loans, experience in other countries indicates that they may not fully reflect the low liquidation values that could ensue if the banks had to quickly liquidate collateral for a wide range of borrowers in the middle of a systemic economic crisis. This is especially true for an economy like Malta's where the economic base is narrow; real estate is the main asset pledged as collateral; there are restrictions on the sale of real estate to nonresidents; and there are some inefficiencies in the

² This compares with an average 0.6 percent return recorded by European banks in 2001, according to the European Central Bank's EU Banking Stability Report (February 2003).

Table 2. Malta: Financial Soundness Indicators for the Banking Sector, 1999–2002

(In percent, unless otherwise indicated)

	Domestic Banks				International banks 1/			
	1999	2000	2001	2002	1999	2000	2001	2002
<i>Capital Adequacy</i>								
Tier I capital to risk-weighted assets	9.5	10.4	10.8	11.9	26.3	28.6	26.7	28.6
Total regulatory capital to risk-weighted assets	14.3	16.0	15.9	16.0	28.0	30.5	28.8	29.9
Capital (net worth) to assets	5.7	6.5	6.7	6.6	18.7	18.1	19.1	19.2
<i>Asset composition</i>								
Sectoral distribution of loans to total loans								
Energy and water	6.9	6.0	5.0	4.9	0.0	0.0	0.0	0.0
Transport, storage, and communication	4.9	5.5	5.7	7.0	0.0	0.0	0.0	0.0
Bank and other financial institutions	2.7	3.1	5.4	4.3	0.9	0.9	1.2	0.9
Agriculture & fisheries	0.7	1.1	0.6	0.5	0.0	0.0	0.0	0.0
Manufacturing, ship repair and shipbuilding	12.5	11.6	10.8	10.0	0.5	0.5	0.4	0.2
Building and construction	5.9	5.7	4.5	4.7	0.0	0.0	0.0	0.0
Tourism	13.2	13.6	13.0	13.3	0.0	0.0	0.0	0.0
Trade	17.4	16.7	15.9	15.5	0.0	0.0	0.0	0.0
Personal loans	21.7	22.1	24.5	27.2	0.0	0.0	0.0	0.1
Other:	14.1	14.6	14.6	12.7	98.6	98.6	98.4	98.8
<i>Of which:</i> Nonresidents	0.5	0.5	1.1	1.3	98.2	98.1	98.0	98.6
Loans in foreign currency to total loans 2/	6.1	5.0	4.6	4.2	100.0	100.0	100.0	100.0
NPLs to Gross Loans 3/	13.0	14.0	18.0	16.2	0.1	0.1	0.4	0.8
Large exposures to Tier 1 capital 4/	319.3	195.3	257.0	232.9	142.4	211.6	185.0	218.2
Gross asset position in derivatives to capital	92.9	66.2	95.5	115.0	24.1	11.5	1.4	1.4
Gross liability position in derivatives to capital	65.7	57.7	51.5	84.9	25.0	11.7	1.4	1.4
<i>Earnings & profitability</i>								
ROA (before tax)	0.9	0.8	0.8	0.8	6.0	4.0	3.4	1.7
ROE (before tax)	15.7	13.3	11.9	12.3	27.9	21.7	18.3	8.8
Interest margin to gross income	68.2	69.4	70.4	70.8	81.6	74.4	80.3	0.4
Noninterest expenses to gross income	60.0	59.9	59.8	72.7	57.1	58.7	21.2	18.1
Personnel expenses to noninterest expenses	59.8	60.6	57.5	48.2	3.8	3.4	19.5	32.0
Trading and fee income to total income	12.6	11.3	11.7	14.2	-21.0	0.1	10.2	23.4
<i>Liquidity</i>								
Liquid assets to total assets 5/	22.9	20.6	25.0	24.8	29.0	22.5	38.1	24.6
Liquid assets to total short-term liabilities 5/	41.1	36.6	46.6	45.1	61.5	64.7	101.4	85.4
Customer deposits to total (non-interbank) loans	139.4	131.9	144.8	162.7	55.3	69.6	73.4	43.7
Liabilities in foreign currency to total liabilities 6/	27.9	27.4	29.4	30.5	96.8	95.0	96.0	97.7
<i>Sensitivity to market risk</i>								
Average repricing period of assets (in years) 7/	n.a.	2.5	2.8	2.5	n.a.	1.6	1.4	1.4
Average repricing period of liabilities (in years) 7/	n.a.	1.0	0.7	0.7	n.a.	1.8	1.3	0.7
Net open positions in FX currency to capital	15.1	16.3	16.3	17.1	n.a.	n.a.	n.a.	n.a.
Net open positions in equities to capital	34.8	31.2	26.8	28.0	4.7	5.2	1.8	3.1

Sources: Central Bank of Malta.

Note: n.a. = not available.

1/ Exclude branches.

2/ Data relating to loans in foreign currency includes lending denominated in external liri.

3/ Data relating to gross loans excludes interbank lending. **In March 2003 the ratio fell to 15.3 for the domestic banks.**

4/ Exposure equals to or exceeding 10 percent but less than 25 percent of the bank's own funds on a net basis.

5/ Liquid assets include cash, central bank balances, excess reserves, T-bills, interbank claims, and marketable debt securities.

6/ Data include foreign securities sold under agreement to repurchase and foreign subordinated loan capital.

7/ Repricing of assets and liabilities include on-balance sheet items only.

judicial system that may hinder the banks' ability to obtain ownership of collateral in a timely cost-effective basis. The mission strongly recommended that the authorities reduce the level of NPLs and strictly enforce the new loan classification and provision requirements introduced in 2001.³ And, as also indicated by some rating agencies, to be vigilant on the quality of the banks' loan portfolios. **In this context, the mission welcomes the CBM's initiative to begin publishing aggregate NPLs data.**

Stress testing

25. **The CBM introduced a quarterly stress testing exercise in 2002 to assess the four domestic banks' ability to cope with various economic and financial shocks.** The mission relied on these stress tests, and supplemented them with an examination of the banks' ability to absorb changes in the average credit quality of their domestic loan portfolio and securities holdings (Box 2). The international and offshore banking institutions operating in Malta were not included because they do not represent a source of systemic risk.

26. **Stress tests for credit risk clearly illustrate how the domestic banks' financial condition is significantly influenced by Malta's narrow economic base.** While banks can readily manage their exposures to individual borrowers, they might have difficulty in coping with shocks that are more systemic in nature due to the limited diversification of their loan portfolios and their reliance on real estate property as collateral in lending operations. Collateral valuations appear to be a major determinant of banks' abilities to weather a deterioration in the average quality of their credit exposures. Given the large indirect exposure to real estate property prices, the authorities should remain vigilant in their appraisal of real estate collateral. The introduction of a real estate price index will be important in this endeavor and for conducting stress tests.

27. **The credit risk stress tests also indicated that the banks' credit risk management systems could be strengthened further.** Although the two largest banks have implemented credit scoring systems, they need to consider further refinements to their systems that would enable them to assess the implications of their economic outlook for future loan losses, and to provision accordingly in a proactive manner. The two smaller banks have yet to introduce formal credit scoring systems.

³ NPLs are classified by past-due and risk criteria. A loan is considered to be nonperforming when it is overdue by 90 days or when there are other reasons to believe that there is doubt as to the collectibility of funds.

Box 2. Malta: FSAP Stress Test Exercise

Credit risk

It was not practical to conduct a “top-down” stress-testing exercise linking the quality of bank loan portfolios to macroeconomic developments for two main reasons. First, the managements of the two largest banks have undergone significant changes. Second, the rules governing credit classification and loan loss provisioning have been significantly revised, undermining the usefulness of a time-series analysis. Therefore, the analysis of credit risk was limited to a forward-looking, “bottom-up” approach that was based on scenario analyses and international rules of thumb.

Exposures to key sectors and large borrowers: Given the highly concentrated nature of bank loan portfolios and close links between economic sectors, the first step was to examine the domestic banks’ capacity to absorb a default by key economic sectors and sub-sectors. This was done by examining their gross exposures to these sectors/sub-sectors relative to their capital base under the extreme scenario that there would not be any collateral available to secure the credit exposure.

Consistent with the high degree of concentration in bank loan portfolios, the results suggest that the banks would be most at risk from private sector defaults in the wholesale and retail trade sector and the household sector. A default by any one of these sectors would result in all four banks needing to raise new capital to meet prudential requirements. Not surprisingly, the banks are in a better position to weather a default of a sub-sector or a large borrower. However, they would be vulnerable if the government defaulted on its debt since government securities and contingent liabilities arising from guarantees represent more than 30 percent of bank holdings of loans and securities.

Capacity to withstand downgrades in credit quality: The effect of a downgrade in the average credit quality of the domestic loan and securities portfolios on the capital of each domestic bank was assessed. Banks were asked to allocate their private sector claims into credit rating buckets that broadly correspond to Moody’s credit ratings. Since the government’s domestic debt is rated single-A by Moody’s, all other credit exposures were rated Baa or below. The expected loss of the total portfolio was then computed using the default probabilities associated with Moody’s credit ratings.¹ The stress test then explored the effect on each bank’s expected credit loss from a downgrade of one and two full grades. However, it was not possible to assess the likelihood of a credit rating change of one or two full grades in the Maltese context.

The stress test results indicate that most of the banks should be able to cope with a decline of one or two full grades in the average credit quality of their private sector exposures. Expected losses in each scenario were less than the sum of their accumulated provisions and collateral pledged by borrowers. The banks’ ability to weather a credit quality decline, however, is very dependent on their being able to liquidate the underlying collateral at a price close to the reported “discounted value” in the event of default.

Market risk

Interest rate risk: Interest rates have been fairly stable in Malta over the years, reflecting in part the interest rate controls that were mostly lifted in the mid-1990s and completely eliminated in 2000. Hence, historical experience could not be used to select plausible interest rate shocks. Instead, interest rate risk was assessed using arbitrary parallel shocks to the yield curve of +/-100, and +300 basis points. The four domestic banks were asked to compute the effects of these shocks on their pre-tax profits using their own internal risk management systems, which are largely based on standard repricing gap analysis. The results suggest that three banks are positioned to profit in the first 12 months from an increase in domestic interest rates. The fourth one has more than enough capital to absorb an interest rate increase without falling below prudential requirements.

Foreign exchange risk: As with interest rates, the stability of Malta’s exchange rate regime meant that past exchange rate movements could not be used to set plausible exchange rate scenarios. Instead, exchange rate risk was assessed using arbitrary shocks of +/- 10, 20, and 50 percent to the value of the Maltese lira against the individual currencies that make up the currency basket (euro, pound sterling, and the U.S. dollar).

Given the tight prudential limits imposed by the MFSA on the banks’ open foreign exchange positions relative to capital, all four banks are well positioned to cope with the direct effects of exchange rate movements. Net open foreign exchange positions in aggregate are not allowed to exceed 20 percent of bank capital, and there are limits of 5 percent on each individual currency exposures (except the euro, where there is a 14 percent limit, since it represents 70 percent of the currency basket). Since all four banks operate with small positive net open positions in foreign currencies, their profits would only decline if the Maltese lira appreciated against the basket currencies. However, given that their net open foreign exchange positions are small, capital adequacy ratios for each of the four banks would stay above the eight percent threshold under all of the scenarios considered.

^{1/} Probabilities of default were constructed using the Moody’s historical transition data for the United States (1980–1999). Rating qualifiers were disregarded for purposes of this exercise. Expected losses equaled gross exposures times’ probability of default. Thus, expected losses would broadly compare to total accumulated provisions recorded on banks’ balance sheets if a zero recovery rate is assumed and no allowance is made for collateral in the event of a loss.

28. **Stress tests for market risk suggest that banks are well positioned to cope with shocks to interest rates, foreign exchange rates, and equity prices.** Except for one small bank, all banks would profit from an increase in domestic interest rates over a horizon for up to 12 months, although profits would decline over the longer run in the absence of changes to their balance sheet structures, since their holdings of longer-term fixed-rate securities represent more than one third of their assets. That small bank, however, seems to have more than enough capital to absorb the tested shocks without falling below prudential requirements. The stress tests also indicate that all four banks are in a position to cope with the direct effects of exchange rate movements given the tight prudential limits imposed by the MFSA on the banks' open foreign exchange positions relative to capital. All banks would benefit from an appreciation of these currencies against the Maltese lira. The banks' exposure to unexpected movements in equity prices is manageable, since equities represent less than 30 percent of capital. Stress tests on market risks incorporate derivative positions that are used to offset balance sheet exposure.

International banks

29. **The international banks operating in Malta have no significant linkages to the domestic financial system and therefore do not pose any systemic risks.** Most of them rely on funding provided by deposits from foreign banks (notably parents/affiliates) and nonresident deposits obtained in part through parent banking groups. Their assets are primarily invested in deposits of foreign banking institutions (in many cases related affiliates), foreign securities, and loans to nonresidents (especially those sourced through their parent's global banking networks). As per agreement with the Maltese authorities, weak loans do not remain on the books of the Maltese entities, but are instead transferred back to the foreign parent. None of these banks has encountered any difficulties.

B. Insurance Companies

30. **The insurance sector is very concentrated, while being indirectly linked to the banking sector.** One local group of insurance companies (Middlesea), which is affiliated with Bank of Valletta and owned in part by the Maltese government, dominates the insurance market and its failure would pose a risk for the systemic stability of the insurance sector. However, the direct links between the insurance and banking industries are limited.⁴

31. **The insurance sector is profitable, with insurers complying with solvency margin requirements even though profitability ratios are on the decline.** The sector is also very conservative in its provisioning, and reinsurance is kept to a reasonable level. Provisions have increased gradually in recent years.

⁴ Bank of Valletta, plc, (an upstream bank holding company) is a shareholder in Middlesea (non-life) and Middlesea Valletta (life) insurance companies. Insurance companies' funding through bank loans is insignificant.

C. Capital Markets

32. **An important issue revolves around the role of the CBM as market maker in the government securities market.** Given the absence of private market-making facilities, the CBM quotes daily bid and offer prices to guarantee liquidity to MGS holders and to stimulate trading in this market. The CBM's pricing policy seeks to be market-driven and is entirely independent of the monetary operations framework. The CBM has been consulting for a number of years with the main market players with a view to encouraging them to take over the market-making role. However, the narrow spread between its prices may have inhibited other participants from becoming market makers. The CBM was encouraged to consider reducing its presence in the market once a system of primary dealers has been implemented.

D. Payment and Settlement Systems

33. **The MaRIS system exhibits no major weaknesses, observing most of the CPSS core principles.** The number of failed payments has dropped significantly from the days after implementation and has currently reached an acceptable level of less than five per day. However, the system is relatively new and all procedures are not yet in place and tested. Some technical issues that should be addressed by the CBM are the relatively high minimum four hours recovery time in case of breakdown, and the lack of a remote back-up site. Moreover, it is important that the CBM develops and tests contingency plans, especially if the system is extended to more members in the future.

34. **Given the size of the Maltese economy, the retail payments infrastructure could be better integrated to become more efficient** by creating a single retail system, which can handle several means of payment.

35. **While the present operational arrangements for the Central System of Securities Settlement (CSS) and the CSS functions in the MSE are appropriate for the nature and size of the domestic market, there are some uncertainties surrounding the role, regulation, and supervision of the CSD.** Being an integral part of the MSE it is difficult to separate the function of the CSD from those of the MSE. As a consequence, there is no direct supervision of the CSD. Ensuring that the CSD has a well-founded legal basis, including finality of securities transactions, should be a priority. At the same time, the authorities should consider placing the CSD in a separate entity. With regard to the supervision and regulation of the securities depository and settlement system, the MFSA and CBM should continue to cooperate closely and establish their respective roles through MoUs.

36. **The Maltese authorities should ensure that the planned steps to introduce DVP in the Maltese securities settlement system are implemented as soon as possible.** Presently in Malta, securities are transferred on the day of trade, while the funds are transferred three days later.

E. Systemic Liquidity and Monetary Management

37. **The CBM uses four instruments to manage banks' short-term liquidity needs—reserve averaging, foreign exchange operations, repo operations, and the marginal lending facility.** The system of required reserves allows full averaging over the one-month holding period. Required reserves are remunerated at a fixed rate of 2.7 percent, which is below market rates. The CBM also stands ready to buy and sell spot foreign exchange in the three basket currencies. Should the entire banking system be short of liquidity, the CBM would inject liquidity through weekly auctions of repurchase agreements with government securities. The collateralized marginal lending (stand-by) facility can be automatically activated to provide overnight loans if a bank account is overdrawn at the end of the day or upon request of banks for up to 12 months. The new MaRIS payment system ensures that, at any time, payments are settled only if enough collateral has been pledged to the CBM. During the day, a lack of funds in a bank's settlement account would result in an intra-day loan; such a loan at the end of the day is accounted for as an overnight loan and is charged a penalty interest rate.

38. **The CBM only accepts government bonds as collateral for CBM loans.** Dematerializing treasury bills and introducing the European Master Repurchase Agreement would not only make them more usable as collateral, it would also make the treasury bill market more accessible to foreign investors and encourage the development of an interbank repo market.

39. **In the current situation of excess liquidity, the CBM manages liquidity through weekly auctions of deposits with a maturity of two weeks in order to accommodate the entire demand for those deposits.** The CBM's overnight deposit facility, which is remunerated below market rates and below the rate of remuneration for required reserves, is typically accessed only on the last day of the reserve maintenance period. The CBM produces daily liquidity forecasts but focuses mostly on the days of the auctions of term deposits or repos. The liquidity forecasting process could be improved by including daily/weekly government cash-flow projections that the Ministry of Finance (MoF) would produce under a new cash-flow management system.

40. **The CBM has an explicit mandate to provide liquidity as a lender of last resort to safeguard the financial stability of the system.** In such circumstances, it can grant collateralized loans to any bank incorporated in Malta against such forms of security as the Board may consider appropriate. The previous recommendations to dematerialize treasury bills and strengthen risk controls are also applicable for strengthening the use of the LOLR facility.

F. Public Debt Management

41. **Malta's public debt management practices are not a source of systemic risk to the financial system.** The debt stock is conservatively managed, as most of it consists of longer-term fixed rate securities denominated in Maltese liri. This leaves the government's

debt service costs well protected against any unexpected sharp fluctuation in interest rates or a significant exchange rate depreciation.

42. **The institutional structure governing public debt management activities, however, is at an early stage of development.** Activities surrounding the management of the debt stock are scattered across several government agencies, including the MOF, the CBM, and the Accountant General's Office. These activities are coordinated by the Public Debt Advisory Committee (PDAC), which consists of senior officials from each of these agencies plus one from the MSE. The authorities are obtaining technical assistance from the Commonwealth Secretariat to help them create a debt management office to centralize the day-to-day debt management activities, and transform PDAC into a group that focuses on strategic issues. Over time, they also plan to introduce more formal risk management procedures so that they can monitor and manage the financial risks embedded in the debt stock in a more rigorous fashion and ensure debt sustainability. One area, which requires close attention, however, is the management of the large stock of guarantees. As state enterprises are privatized over time, any associated guarantees should be either extinguished or priced appropriately.

43. **The authorities were also encouraged to follow through with their plans to take a broader view of public debt management, using it as an instrument to help develop more liquid domestic capital markets over the medium term.**⁵

G. The Supervisory and Regulatory Framework

Banking supervision and regulation

44. **The authorities' compliance with the *Basel Core Principles for Effective Banking Supervision* is good.** While the structure of the MFSA is clearly established, the internal governance process should be more explicit and further developed. The Supervisory Council, represented by the Director General and the heads of each arm of supervision, is responsible for licensing decisions and for monitoring and supervision of entities licensed by the MFSA. The review of this body's oversight function and of the information flows it receives disclosed the need to have more developed rules of procedure. The Council, being responsible for key supervisory decisions, must ensure that it receives timely and comprehensive information on the status of supervised entities, particularly if deteriorating trends or problems are detected, so that it may effectively execute its responsibility and make well-informed decisions. Similarly, the supervisor should further emphasize sound

⁵ The Guidelines for the Public Debt Management, developed by the IMF and World Bank, and the Accompanying Document to those Guidelines provide guidance and country examples on these issues (www.imf.org/external/np/mae/pdebt/2000/eng/index.htm).

governance in the industry by explicitly holding boards accountable for the condition and performance of their banks.

45. **Supervisory enforcement and corrective action are also key areas requiring attention.** In the past, the supervisor has made active use of “moral suasion” in problem situations. While this resulted in gradual corrective action, it also involved some delay to elicit response. In cases where a supervisory response is needed in order to address poor bank management or to arrest unsafe and unsound activity, the supervisor should ensure that definable actions are taken promptly.

46. **There is currently no legal provision requiring the supervisor to take prompt corrective action (PCA) based on certain evolving and existing conditions.** Consideration could be given to developing a PCA provision that requires the supervisor to take gradually increasing remedial action when certain conditions exist. Also, the supervisor should have some form of written formal agreements or memorandum of understanding in the case of significant problems, not necessarily exclusively based on capital impairment. An amendment to the Banking Act or other legislation may be necessary to ensure the enforceability of such regulatory directions. Furthermore, the magnitude of monetary penalties for breaches of regulation may not have the desired impact and the penalty structure should be revisited.

47. **Increased emphasis on the overall assessment of banks’ internal risk management systems and the methods (accuracy and effectiveness) of risk measurement, monitoring, control and reporting should be elevated to a higher level.** The credit risk instructions provided in the Banking Directive 09 are generally adequate, however there is an opportunity to strengthen classification and provisioning guidance.

48. **Additional focus is also needed on collateral valuation and the subsequent credit given to it in the classification and provisioning process.** Currently, full credit is given to collateral values when making loan provisions. No guidelines or directives are in place to address acceptable collateral valuation processes. This is particularly important, as there are legal impediments to efficient foreclosure and liquidation actions. Without rigorous collateral valuation guidelines and given the dependence on collateral to support required loan loss provisions, the accuracy of classifications and loan loss provisions could be potentially questioned.

49. **The supervisory process and the examination technique practiced by the supervisors are good.** However, there is a need to enhance the impact, the accuracy, and the timeliness of examination results through several steps.

50. **Capital adequacy figures reflecting examination classifications and provisioning results should be presented in the reports of examination and be included in the supervisor’s monitoring systems and documentation.** If material misstatements of financial position have been made by the bank based on these results, any pertinent violations of law and supervisory actions should be triggered.

51. **The appropriate legal provisions are in place to allow information sharing and reciprocal cooperative agreements with foreign supervisors.** However, no MoUs are yet in place. The supervisor should continue to pursue communications with foreign supervisors in order to further establish its reputation as an effective and transparent regulator, thereby enhancing the reputation of the Maltese banking system. Efforts to formalize cooperative agreements with the pertinent authorities should continue.

Insurance supervision and regulation

52. **The authorities have made significant progress in creating an effective insurance supervisory framework and comply with most *IAIS Core Principles*, but some areas need further strengthening.** In particular, (a) the MFSA should formalize insurance company corporate governance procedures; (b) work is needed to move to a more formal risk-based approach to supervision; and (c) a consistent approach in the respect of exchange of information with foreign insurance supervisory authorities should be developed.

Securities markets supervision and regulation

53. **Observance of *IOSCO Objectives and Principles for Securities Regulation* is good.** However, given the extent of the recent legislative reform, it is too early to assess the enforcement track record under the new regime. The MFSA's new supervisory and regulatory responsibilities are likely to place serious strains on MFSA staff resources given the mismatch between the large number of regulatory subjects and the number of staff in the MFSA Investment Services Unit. The enforcement powers are appropriate and well established in law, and the established enforcement practices to date also seem appropriate. The statutory capital requirements of the stock trading and investment services firms should be risk-adjusted.

Payment systems

54. **The CBM, which is the competent authority in the area of payment systems, shows a strong observance of the *CPSS Core Principles for Systemically Important Payments System*, although further work is needed to improve the securities settlement system.** According to the Central Bank of Malta Act, no person should organize, establish, operate, and participate in a domestic payment system unless such system is approved and authorized by the CBM.

H. Transparency of Monetary and Financial Policies

55. **The CBM has made significant efforts to improve the transparency of monetary policy and observes most of the transparency practices outlined in the *Code of Good Practices for Transparency in Monetary and Financial Policies*.** In this context, the amended CBM Act, which came into effect in October 2002, is in line with EU requirements. The amended Act focuses monetary policy on the pursuit of price stability, reinforces the

independence of the CBM, and clarifies the CBM's role in fostering financial stability. In the transparency area of monetary policy, the main shortcomings of the central bank in this area of transparency relate to the lack of clarity in the description of the objectives and procedures of the CBM's operations in government securities markets, and the lack of monthly information about the CBM's off-balance sheet commitments, especially its forward contracts in the foreign exchange market. Improvements in the transparency of financial policies should be made by clearly defining and publicly disclosing both (i) the roles of the MFSA and CBM in regulating and supervising the securities depository and settlement system, and (ii) the arrangements for the exchange of information between domestic as well as international supervisory and regulatory authorities.

I. Legal Framework and Judicial System

56. **Malta has a sound and well-established legal system that is based upon a unique combination of civil and common law provisions and principles, which have been successfully blended to accommodate the country's history and traditions.** Respect for the rule of law, the judiciary and the legal profession is high. The courts are regarded as responsive to the needs of the people although delays in the resolution of commercial cases are widely regarded as excessive.

57. **The financial sector laws and regulations are comprehensive in scope, well drafted and consistent with international best practices.** Following the decision to move to a single regulator, the financial sector reforms that were introduced between 1994 and 1998 have been substantially revamped in the last two years and brought into line with EU norms and directives and international standards. New legislation covering the banking, securities, insurance and anti-money laundering sectors is now in place or about to be enacted. The pace and scope of reform is impressive and the authorities are to be commended for their readiness to adjust the country's legal and institutional framework to reflect external developments without compromising its essential legal traditions. The result is that Malta has a legal framework that is responsive to the needs of the international financial and business community. Modern securities market legislation has been enacted that is in line with European practice.

58. **The collateral/debt enforcement provisions are satisfactory but implementation tends to be more problematic.** The land registration system appears to work well, although significant areas of Malta are still not subject to individual title. The company register is highly efficient and accessible on-line. The only significant area of concern relates to what is widely regarded as excessive delays in resolving court cases. In this context, the one area that merits review is the speed at which commercial cases are resolved and judgments are successfully enforced. The insolvency regime is comprehensive although it lacks a corporate restructuring, that is, the development of a "Chapter 11"-type facility. This change is under consideration. Reforms in this area may be required to ensure that the business community retains respect for the courts as the primary dispute resolution mechanism.

J. Financial Stability Policy and Safety Nets

59. **Malta's banking system has never experienced a systemic crisis. However, a contingency plan exists and is in the process of being refined.** The plan is designed to help coordinate authorities' action in the event of a crisis. Based on the classification of the severity of the crisis, a set of possible responses is prescribed in the plan. As a part of these actions (as well as on an ongoing basis), coordination and exchange of information with the CBM is required. The Financial Stability Office of the CBM is in the process of developing an Early Warning System, based on the prudential returns of the reporting institutions. This system includes the monitoring of the local large borrowers' financial situation by means of the examination of their financial statements and banking exposures. This is related also to the situation that no rating agencies operate in Malta. The Financial Stability Office produces a stability report that analyses the banks credit risk management issues and the trends of nonperforming loans and provisions. These analyses are discussed on an informal basis with MFSA, with which regular contacts and exchange of information are in place. A permanent MOU between the MFSA and CBM, covering also coordination issues in the event of a banking crisis, was signed on February 4, 2003. Under this new MoU, the CBM will be responsible for the maintenance of the database, which comprises statistical and prudential information sent by the reporting institutions.

60. **The legislative amendments enabling the setting up of a Deposit Guarantee Scheme and the Investor Compensation Scheme were approved by Parliament in July 2002.** The new regulation, which provides the legal basis for the scheme, entered into force January 3, 2003. The scheme is being developed along the lines of EU standards. It will be under the general control of a Management Committee, recently appointed by the MFSA, and is a corporate body having a distinct legal status. Apart from special circumstances (winding up by the Court or voluntary winding up), the MFSA has the power to trigger the activation of the scheme within 21 days from the day that any particular credit institution is unable to meet its obligations arising from claims by its depositors. The sources of funding for the scheme will include contributions from participants, and other sources.

61. **Every credit institution that is licensed in Malta under the Banking Act shall participate in the scheme, including a branch of a credit institution operating in another country.** The total amount of compensation that may be paid out to any depositor shall be the lesser of 90 percent regarding that depositor's eligible deposits, or up to the Maltese equivalent of EUR 20,000, in line with the EU minimum level of protection.

K. Anti-Money Laundering and Combating the Financing of Terrorism

62. **The authorities in Malta have long recognized the importance of an effective AML/CFT regime and have demonstrated a strong commitment to fulfilling their international obligations in this area.** The legislative framework, first enacted in 1994, has been updated and strengthened on several occasions, most notably in 2001/02. The authorities have played an active role in international fora and in the development of international AML/CFT standards.

63. **Malta has put in place a legal framework which is comprehensive, well established and broadly consistent with international standards.** It has signed, ratified, and adopted most of the key international conventions, treaties, and UN Resolutions relevant to AML/CFT and is committed to achieving full compliance. No major legislative or regulatory gaps have been identified although, as the authorities acknowledge, in order to achieve full compliance with the legal and institutional aspects of the methodology, some technical refinements will be required in the current regulations and guidance notes. In this respect, for example, the issue of whether the financing of terrorism has been adequately criminalized needs to be further considered. In addition, a number of specific aspects from the Basel Committee's *Customer Due Diligence* paper, relating in particular to the implementation of measures for high-risk customers, need to be incorporated into the regulations or guidance notes, as appropriate.

64. **All of the institutional elements necessary to support an effective AML/CFT regime are in place, following the establishment of the FIAU, which became fully operational in October 2002.** It is not feasible at this early stage of its operation to assess in detail the effectiveness of the FIAU. However, the Unit is expected to be in a position during 2003 to satisfy the requirements for membership of the Egmont Group of financial intelligence units. The current level of Suspicious Transaction Reports in Malta appears low by international comparison. With the creation of the FIAU, it would be expected that increasing awareness in the financial system could result in a significant increase in reporting. The level of resources available to the FIAU should be kept under review to ensure that it is adequate to meet growing demands on its expertise.

65. **The implementation of the AML/CFT regime has been integrated into the ongoing supervision of all regulated institutions.** While the FIAU is the designated competent authority for AML/CFT, the MFSA, as single regulatory authority for banks, securities firms, insurance businesses, and bureaux de change carries out a program of on-site and off-site supervision into which AML/CFT is incorporated. It is recommended that the level of resources and specialist expertise in the area of AML/CFT in the MFSA should be reviewed and increased as necessary to expand the program of on-site inspections to include, in particular, the international banks and a sample from the branch network of the domestic banks. A high standard of awareness, acceptance, and implementation of the AML/CFT provisions has been observed in the course of the mission in a range of regulated institutions.

66. *In the area of law enforcement, the explicit introduction is recommended, equally for drug and non-drug related investigations, of all possible investigative measures on ML/FT in the work of the police. Consideration should be given to the development of specialist expertise within the Economic Crimes Unit of the police in the areas of CFT and AML analytics.*⁶

⁶ Assessment of criminal law enforcement measures was conducted by an expert not under the supervision of Fund and Bank staff. Portions of the assessment attributable to him are shown in italicized text.

67. **When reviewing the current regime for nominees, particular attention should be given to risk control in the area of AML/CFT.** It is acknowledged that nominees are regulated in their own right by the MFSA and are required to apply customer due diligence procedures. However, for such business, which is high-risk and with potential reputational implications for Malta, additional measures are recommended with respect to financial transactions of nominee companies. In particular, current bank identification requirements should be extended to require the independent application by regulated financial institutions of full customer identification procedures, as are applied to customers generally. The same recommendation would apply equally to the proposed amendments to the trust regime. While the strengthening of regulatory requirements in the current draft legislative proposals is to be welcomed, they cannot be assessed in detail at this time, since the associated regulations have yet to be drafted.

FINANCIAL SYSTEM OVERVIEW

A. Institutions

The banking sector

68. **The banking sector is by far the largest segment of Malta's financial system (Table 3).** It also dominates the insurance and securities industries, through subsidiaries and affiliates in these sectors. It consists of a domestic and an international component that operate independently of one another. The domestic component is highly concentrated, and consists of four banks. The two largest are roughly the same size. They dominate the sector, representing more than 90 percent of domestic system assets, with similar shares of the deposit and loan markets for residents. The two large banks also dominate the insurance and securities industries, through subsidiaries and affiliates in these sectors. Maltese bank profit margins and operating expenses are broadly comparable to those in the EU.

Table 3. Malta: Financial System Structure, 1998–2002

	Dec-98		Dec-99		Dec-00		Dec-01		Dec-02	
	Number	Assets (Liri mill.)	Number	Assets (Liri mill.)	Number	Assets (Liri mill.)	Number	Assets (Liri mill.)	Number	Assets (Liri mill.)
Deposit money banks	5	2,647	5	2,937	4	3,187	4	3,590	4	3,911
Private	4	2,647	5	2,937	4	3,187	4	3,590	4	3,911
Domestic	4	2,647	3	1,629	3	1,836	3	2,028	3	2,238
Foreign	0	0	2	1,308	1	1,351	1	1,562	1	1,673
State-owned	1	n.a.	0	0	0	0	0	0	0	0
International banks 1/	9	1,892	11	1,856	14	2,186	10	1,868	9	2,835
Offshore banks	4	n.a.	4	670	4	859	3	765	1	n.a.
Insurance companies 2/	28	152	26	186	24	215	21	251	21	n.a.
Life	6	83	6	114	6	142	5	168	5	n.a.
Nonlife	22	70	20	71	18	74	17	82	16	n.a.
<i>Memorandum item:</i>										
Nominal GDP		1,362		1,456		1,558		1,630		1,685

Source: Central Bank of Malta, and Malta Financial Services Authority.

1/ Total assets for December 2002 includes one offshore bank.

2/ The three insurance companies that are composite have been grouped in the category of their major business. The subtotals of life and non-life companies do not sum up to the total insurance companies.

69. **The international component consists of 10 international banks and 1 remaining offshore bank that deals mainly with nonresidents in foreign currency.** The international banks mainly consist of branches and subsidiaries of Austrian and Turkish banks that have established offices in Malta mainly for tax purposes. The last offshore bank, Erste Bank, plans to become an onshore international bank in 2003.

70. **Government involvement in the banking system has been significantly curtailed.** The 70 percent government stake in Mid-Med Bank was sold in 1999 to HSBC, and its stake in Bank of Valletta reduced to 25 percent.

71. **The level of financial intermediation in Malta is high by EU accession country standards.** M2 exceeds 150 percent of GDP and credit extended to the private sector is more than 90 percent of GDP. To a very large extent, this results from the many years of stability in the banking system. In addition, Maltese residents have historically held significant amount of funds offshore. Some of this offshore money was repatriated to Malta in 2002 in response to several factors, notably: a temporary tax amnesty program; wider spreads between Maltese and European interest rates; and weaker international equity markets. Overall, the banking system contributes about 6 percent of GDP, and employs about 2.5 percent of the labor force.

Offshore and international financial services

72. **Malta's separate offshore supervisory regime is now close to elimination.** Malta marketed its offshore regime between 1988 and 1994, with offshore businesses then given until September 2004 at the latest to either convert to the domestic regulatory standard or cease operations. Only one bank remains under the offshore regime and will soon convert. The authorities continue to encourage the conduct from Malta of international financial services business to which they will apply regulatory requirements equivalent to those applied in the domestic market. Among banks holding licenses in Malta, as noted, a number choose to specialize in business with nonresidents. Although classified as international banks, this reflects an administrative categorization rather than any legal distinction in their licensing. The mission recommends that additional supervisory attention be given by the MFSA to banks conducting international business while noting that they are small and limited in the range of activity. This may necessitate some increase in the frequency of on-site inspection work. With regard to consolidated supervision of international banks, the MFSA seeks to maintain close contact with the relevant home country regulators (particularly in Austria and Turkey).

73. **Malta is also in the course of eliminating offshore nominee companies.** Of the 2,600 such companies on the register (from a total number of companies registered in Malta of approximately 30,000), less than 300 remain. The last of these must cease operations by September 2004. Nominee companies are used mainly to shield their beneficial owners from being publicly identified, for tax and other reasons. Under Maltese legislation, the providers of this nominee registration service are regulated and subject to AML/CFT provisions. While these structures do not have direct implications for financial stability, abuse of the anonymity involved could cause reputational damage to Malta. The authorities are currently considering a proposal to terminate the overall nominee structure, not just the element that operated under the offshore regime. In its place, an expanded trust structure would be introduced, the legislation for which is in final draft and has been seen by the mission. A high level of anonymity would remain, being inherent in trust arrangements. The draft legislation includes provisions dealing with access to identification information in respect of all parties to the

trusts for the regulatory and tax authorities and for regulated institutions providing the trusts with financial services.

The nonbank financial sector

74. **The nonbank financial sector is very small in asset terms, but contributes about 3 percent of GDP.** Twenty-one insurers (all onshore) operate in Malta but the sector is highly concentrated on only two of them. Total assets equal to about 15 percent of GDP. The insurance sector is growing strongly. Total assets nearly doubled over the past four years with life insurance business providing the main impetus for growth. Nevertheless, penetration and density ratios are still low compared to EU member countries. There are no private pension schemes, mortgage institutions, credit unions/cooperatives, or microfinance institutions.

B. Markets

75. **The Maltese domestic capital market is small, the number of available investment vehicles is limited, and the secondary market is currently very thin** (Table 4). The mission recommended some improvements in the infrastructure, but a major development of the market could be envisaged through the integration with the EU market. The Malta Stock Exchange commenced operation in 1992. Share prices rose in tandem with the global demand for equities until 2000, and since then have fallen in line with international developments. Corporate bond issuance has been low, but picked up in 2002.

76. **The CBM actively quotes bid and offer prices for government securities in its role of market maker in the secondary market.** This was triggered by the lack of private market-making initiatives, and it was introduced to enhance investors' confidence. However, with virtually no government securities in its portfolio, the CBM has been able to operate only on the buy-side of the market. Government bonds, which are often held to maturity, have historically represented an important savings vehicle for Maltese residents in the absence of private pension schemes and in view of the one pillar Pay-as-You-Go system.

77. **Trading activity in the Maltese lira money market is very low due to the excess liquidity in the banking system and the small number of banks.** The money market consists of an unsecured cash market and a treasury bill market. Treasury bills, almost all of which are held by banks, are not dematerialized, and trading is on an unregulated over-the-counter basis. Due to the high excess liquidity in the banking system, currently very few interbank transactions occur—whether in treasury bills or in unsecured bank claims. Interbank interest rates, which are mostly in a one-week tenor, are very closely aligned with central bank rates, and are relatively stable, since all banks tend to be on the same side of the market. There are no interbank repo markets, nor other instruments such as commercial paper or certificates of deposit.

Table 4. Malta: Capital, Money, and Foreign Exchange Markets, 1998–2002

	1998	1999	2000	2001	2002
Interbank money market					
Turnover (Liri millions)	955	955	301	208	98
Turnover to GDP (in percent)	70.1	65.6	19.3	12.7	5.8
T-bill market					
Turnover (Liri millions)	344	287	74	154	124
Turnover to GDP (in percent)	25.3	19.7	4.7	9.4	7.4
Government bonds					
Turnover (Liri millions)	109	48	53	125	41
Turnover to GDP (in percent)	8.0	3.3	3.4	7.7	2.4
Turnover to capitalization (in percent)	17.2	6.8	8.1	15.4	5.0
Equities					
Market capitalization (Liri millions)	296	790	882	610	552
Market capitalization to GDP (in percent)	21.8	54.3	56.5	37.4	32.8
Turnover to market capitalization (in percent)	7.2	17.4	9.2	3.4	3.8
Corporate bonds					
Market capitalization (Liri millions)	27	41	106	108	159
Market capitalization to GDP (in percent)	1.9	2.8	6.8	6.6	9.4
Turnover to market capitalization (in percent)	5.8	5.1	4.2	13.9	6.5
Foreign exchange					
Turnover (Liri millions)	1,783	2,504	2,499	2,393	2,811
Turnover to GDP (in percent)	130.9	172.0	160.0	146.8	166.8

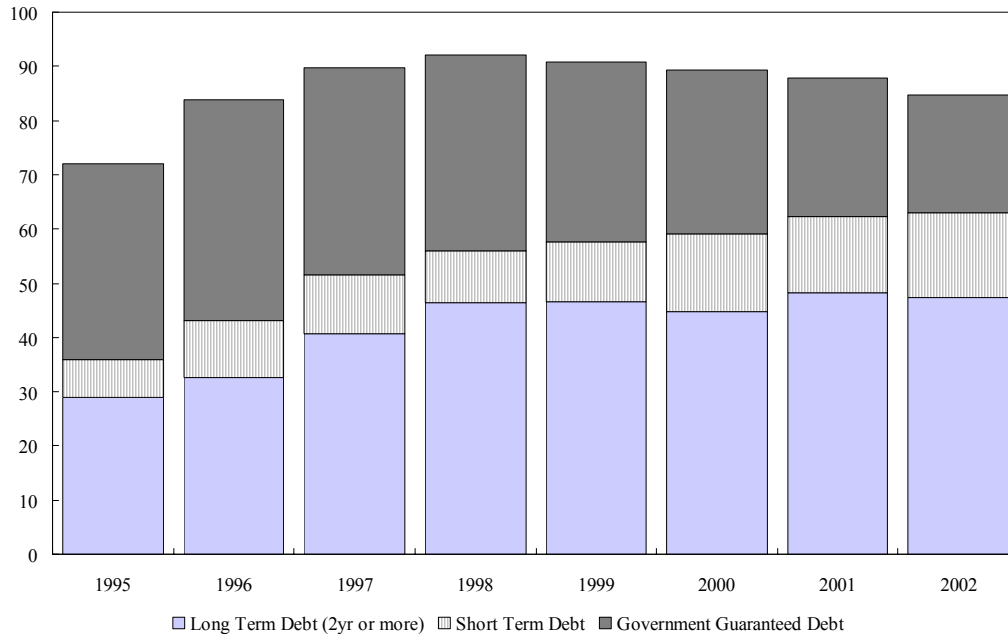
Sources: Central Bank of Malta, and Malta Stock Exchange.

78. **The most active financial market in Malta is the foreign exchange market with a turnover of over 167 percent of GDP in 2002.** However, this is low compared to other EU accession countries and also given the openness of the Maltese economy. The thinness of the market is largely due to strong seasonality, often resulting in banks being on the same side of the market, and because exporters and importers use foreign currency accounts to manage their foreign currency flows.

C. Public Debt Management

79. **Malta's direct public debt stood at 64 percent of GDP in December 2002, while government-guaranteed debt amounted to an additional 22 percent** (see Figure). Most of the debt is denominated in Maltese liri, since Malta has not issued any foreign currency denominated securities. Some 75 percent of the direct debt consists of fixed-rate bonds with maturities ranging up to 20 years. The maturity profile of government securities is well-balanced and only 26 percent of bonds and treasury bills outstanding mature in one year or less. The stock of guarantees mainly consists of those provided by the government to domestic banks to cover loans granted to government agencies and state-owned enterprises. Banks hold most of the treasury bills (73 percent), while most bonds are held by nonbank financial institutions and the general public (52 percent).

Malta: Total Government Debt, 1995–2002
(In percent of GDP)



D. Payment and Settlement Infrastructure

80. **In August 2002, the CBM introduced a sophisticated RTGS system (MaRIS), which handles large-value interbank and customer transactions and is operated and supervised by the CBM.** The amendments to the CBM Act have given to the CBM the legal powers for regulating and overseeing all payments systems in Malta. The four deposit money banks and the CBM participate in the system, which handles a daily average of 140 transactions for a value of Lm 50 million.

81. **The retail payments infrastructure in Malta remains relatively fragmented with traditional payment instruments, most notably checks, being widely used.** The only retail payment system is the CBM-operated Malta Clearing House, which is responsible for clearing checks and money orders. In contrast, the securities settlement system in Malta is highly integrated. The MSE provides for trading and clearing of securities. It also owns and operates the central securities depository. All securities in Malta, except treasury bills and collective investment schemes (CIS), are dematerialized.

E. Supervisory Framework

82. **Banking supervision has made substantial progress since the start of the bank regulatory process in 1970 when the first Banking Act was implemented.** The legislative

framework is in substantial compliance with EU directives and with international standards. The banking supervisors practice a method of risk-based supervision. Through the supervisors' knowledge of a particular institution (through on- and off-site supervision) and based on its risk profile, on-site examinations are conducted of specific risk areas, internal audit, and other areas. Staffing is adequate, and additional personnel have been added when needed. Staff are generally qualified, with much emphasis placed on training, participation in international best practice forums, and fluid communication with both the industry and international parties. The bank supervision department has built a platform from which it can continue to further evolve and enhance its practice.

83. **The process of building an insurance supervision framework was initiated in 1994.** The MFSA has introduced comprehensive prudential rules and regulations in 2000, and has inspected all insurance companies and intermediaries at least once since 2001. The MFSA also grants, refuses or revokes licenses, approves mergers, split and separation of insurers, and initiates bankruptcy proceedings.

84. **The regulation of the Maltese securities market has been transformed by the October 2002 amendments to the financial sector legislation.** These amendments aim to create a single competent regulatory authority for the entire capital market in the MFSA, with the MSE retaining a status of a Recognized Investment Exchange (RIE). All regulatory powers have accordingly been placed with the MFSA.